Internal Revenue Service

memorandum

TL-N-2269-88
CC:TL:TS
TSANDERSON

date: MAR 4 1988

to: Assistant District Counsel, Newark MA:NEW
Attn: Frank Strapp, Jr.

from: Director, Tax Litigation Division CC:TL

subject: Request for Technical Advice [redacted]

This memorandum responds to your request for technical advice of December 31, 1987, and subsequent telephone conversations between Frank Strapp and Ted Sanderson of the Tax Shelter Branch.

Issues

1. Whether the petitioner, [redacted], qualifies for the per se rule under section 108(b).

2. Whether the petitioner's straddle losses were incurred in the trade or business of trading securities.

Conclusions

1. The petitioner does not meet the definition of a "commodities dealer" in section 108(f); therefore, he does not qualify for the per se rule under section 108(b). There is no other per se rule or exception for individuals, either in the statute or the legislative history. The petitioner must show that the straddle losses were incurred in a trade or business or were from transactions entered into primarily for profit.

2. It does not appear that the petitioner can prove that the straddle losses were incurred in a trade or business even assuming he can show he was in the trade or business of trading securities.

Facts

This case involves the years [redacted] to [redacted]. During these years, the petitioner conducted gold and silver straddle transactions on domestic, regulated exchanges. The losses from these transactions were disallowed on audit, in part on the basis of lack of profit motive, with the gains from the gain legs correspondingly removed.

The petitioner traded securities for his own account during the years in issue, and alleges that his trading was significant enough to be considered in the trade or business of trading securities. The petitioner was not in the trade or business of trading commodities nor does he come within the definition of a "commodities dealer" under section 108(f) of the Tax Reform Act of 1984, as amended by section 1808(d) of the Tax Reform Act of 1986. The petitioner contends that his straddle losses were incurred in his trade or business of trading securities.

Discussion

Section 108(b) of the Tax Reform Act of 1984, as amended, sets forth a per se profit motivation rule which was enacted to protect purported commodity dealers in their straddle transactions. Section 108 of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 630, provided in part.

> SEC. 108 TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.
>
> (A) GENERAL RULE - For purposes of the Internal Revenue Code of 1954 in the case of any disposition of one or more positions - (1) which are entered into before 1982 and form part of a straddle, and (2) to which the amendments made by Title V of the Economic Recovery Tax Act of 1981 do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such position is part of a transaction entered into for profit.
>
> (B) PRESUMPTION THAT TRANSACTION ENTERED INTO FOR PROFIT - For purposes of subsection (a), any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts shall be rebuttably presumed to be part of a transaction entered into for profit.

Section 1808(d) of the Tax Reform Act of 1986 made technical corrections to section 108, in part, as follows (Pub. L. No. 99-514, 100 Stat. 2817)

> (d) Section 108 of the Tax Reform Act of 1984 is amended - (1) by striking out "if such position is part of a transaction entered into for profit" and inserting in lieu thereof "if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business." (2) by striking subsection (b) and inserting in lieu thereof the following

> "(b) LOSS INCURRED IN A TRADE OR BUSINESS. - For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business."

Petitioner admittedly does not come within the definition of a "commodities dealer" as provided in section 108(f), also as amended by section 1808(d) of the Tax Reform Act of 1986. Therefore, the per se rule of section 108(b) does not apply. The petitioner must show that the straddle losses were incurred in a trade or business or were from transactions entered into primarily for profit. 1/ There are no other presumptions or exceptions available to an individual, either under the statute or the legislative history.

We reject the petitioner's contention that he could be considered in the trade or business of being a "trading firm," as the term is used in the legislative history. The relevant portion of the legislative history provides:

> Further, if a trading firm also regularly trades commodities in connection with its business, then the commodities trading will be deemed to be part of its trade or business. The latter rule applies only to the securities trading firm itself; it does not apply to separate individual trading of its partners, principals, or employees, nor to partnerships or other organizations formed for the principal purpose of marketing tax straddles.

H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. II-845 (1986), reprinted in 1986-3 C.B. vol. 4.

It is our position that this legislative history, read in context with the remainder of the Conference Report, shows that Congress, when it used "trading firm," contemplated an entity which was not an individual.

Petitioner's main contention is that he was in the trade or business of trading securities, not that he was in the trade or business of trading commodity futures. Therefore, the petitioner must show not only that he was indeed in the trade or business of trading securities, but that the commodity straddle transactions

---

1/ We advise against totally relying on the fact that the petitioner has the burden of proof on the trade or business issue. An argument could be made that the government should at least have the burden of going forward with the evidence on this issue since this ground for disallowance was not asserted in the statutory notice of deficiency.

were an integral part of that business. 2/ The petitioner admits as much when he stated in his "[redacted]" (dated [redacted]) that a "nexus" between the commodity straddles and the trade or business must be demonstrated. The petitioner's argument in this regard is as follows:

> In this case petitioner will show that as a principal and a trader in any specific stock, he selected the stock based on his expectation that the stock would out perform the overall market or in response to his duties as an RCMM. To insure a profit, the movement of the overall market had to be neutralized. Because the overall market is highly interest rate sensitive, the petitioner will show that he attempted to neutralize this factor affecting his overall profitability through the use of those commodity straddles which were principally interest sensitive and not subject to external forces. An example of external forces, weather, drought, and pestilence could affect crop futures and industrial shortages could effect [sic] copper and platinum. Gold or silver were more exclusively interest sensitive.

Frankly, we do not see the merit in this argument. Assume that the petitioner could show that a change in interest rates causes a change in stock prices and an inverse change in the price of gold and silver; then an open position in gold or silver could have the effect of neutralizing the change in stock prices caused by a change in interest rates. 3/ However, the petitioner's positions were part of straddles; any gain on the long position would be offset by a loss on the short position and vice versa. Thus there could be no neutralizing effect on the change in stock prices.

2/ We have attached a memorandum to give you an idea of the arguments that can be made concerning the straddle transactions not being a part of a trade or business of trading securities. See also Paoli v. Commissioner, T.C. Memo. 1988-23 (January 21, 1988). As to the trade or business issue see Commissioner v. Groetzinger, 107 S. Ct. 980 (1987); King v. Commissioner, 89 T.C. No. 35 (1987); Beals v. Commissioner, T.C. Memo. 1987-171 (March 30, 1987).

3/ We do not address the issue of whether offsetting positions in stock and gold or silver could themselves constitute straddles. See I.R.C. section 1092(c).

It appears that the only nexus between the security transactions and the straddles was that the straddle losses offset gains from securities, thereby deferring the gains. Moreover, in [redacted] the petitioner had long-term capital gains from the straddles, effectively converting earlier short-term capital gains from securities to long-term. Therefore, the two principal objectives of tax-motivated straddle trading--deferral and conversion--were achieved at least in part. See Smith v. Commissioner, 78 T.C. 350 (1982). A close examination of the original returns also reveals that gain other than that from the petitioner's security trading was offset, e.g., the [redacted] return shows that the straddle losses were used to offset petitioner's distributive share of net short-term capital gain from various entities. This is additional evidence that these transactions were not an integral part of a trade or business but were primarily tax motivated.

On the basis of the information provided to us, including your expert's report and opinion that the straddle transactions were closed and "switched" in typical tax-motivated fashion, we do not think the hazards are substantial that the petitioner could prove the straddle losses were incurred in the trade or business of trading securities, assuming he can show he was in such a business.

If you need any additional help in developing this case for trial, please do not hesitate to contact Ted Sanderson on (FTS) 566-3233.

MARLENE GROSS

By Kathleen E. Whatley
KATHLEEN E. WHATLEY
Chief, Tax Shelter Branch
Tax Litigation Division

Attachment:
As stated.